

in paragraph (j)(2) and (3) of this section, this section applies to payments of interest made on or after January 6, 2017. (For the rules that apply after June 30, 2014, and before January 6, 2017, see this section as in effect and contained in 26 CFR part 1, as revised April 1, 2016. For payments of interest made after December 31, 2000, and before July 1, 2014, see this section as in effect and contained in 26 CFR part 1, as revised April 1, 2013.)

(2) *Portfolio interest not to include interest received by 10-percent shareholders.* Paragraph (g) applies to interest paid after April 12, 2007. Taxpayers may choose to apply the rules of paragraph (g) to interest paid in any taxable year not closed by the period of limitations as of April 12, 2007, provided they do so consistently for all relevant partnerships during such years.

(3) *Portfolio interest not to include certain contingent interest.* The rules of paragraph (h) of this section apply beginning September 18, 2015.

[T.D. 8734, 62 FR 53416, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72184, 72187, Dec. 31, 1998; T.D. 8856, 64 FR 73409, 73412, Dec. 30, 1999; T.D. 9323, 72 FR 18387, Apr. 12, 2007; 72 FR 26543, May 10, 2007; T.D. 9658, 79 FR 12746, Mar. 6, 2013; 79 FR 37182, July 1, 2014; T.D. 9734, 80 FR 56879, Sept. 18, 2015; T.D. 9808, 82 FR 2055, Jan. 6, 2017]

§ 1.871-15 Treatment of dividend equivalents.

(a) *Definitions.* For purposes of this section, the following terms have the meanings described in this paragraph (a).

(1) *Broker.* [Reserved]. For further guidance, see § 1.871-15T(a)(1).

(2) *Dealer.* A *dealer* is a dealer in securities within the meaning of section 475(c)(1).

(3) *Dividend.* A *dividend* is a dividend as described in section 316 (even if there is no actual distribution of cash or property).

(4) *Equity-linked instrument.* An *equity-linked instrument (ELI)* is a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, that references the value of one or more underlying securities. For example, a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one

or more underlying securities is an ELI.

(5) *Initial hedge.* An *initial hedge* is the number of underlying security shares that a short party would need to fully hedge an NPC or ELI (whether the NPC or ELI is a complex contract or a simple contract benchmark (within the meaning of paragraph (h)(2) of this section), as appropriate) with respect to an underlying security at the calculation time for the NPC or ELI, even if the short party does not in fact fully hedge the NPC or ELI.

(6) *Issue.* An NPC or ELI is treated as issued at inception, original issuance, or at the time of an issuance as a result of a deemed exchange pursuant to section 1001.

(7) *Notional principal contract.* A *notional principal contract (NPC)* is a notional principal contract as defined in § 1.446-3(c).

(8) *Option.* An *option* includes an option embedded in any debt instrument, forward contract, NPC, or other potential section 871(m) transaction.

(9) *Parties to the transaction—(i) Long party.* A *long party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be entitled to receive a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(ii) *Short party.* A *short party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be obligated to make a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(iii) *Party to the transaction.* A *party to the transaction* is any person that is a long party or a short party to a potential section 871(m) transaction, any agent acting on behalf of the long party or short party, or any person acting as an intermediary with respect to the potential section 871(m) transaction.

(iv) *Party to the transaction that is both a long party and a short party—(A) In general.* If a potential section 871(m) transaction references more than one underlying security, the long party and short party are determined separately

with respect to each underlying security. A party to a potential section 871(m) transaction is both a long party and a short party when the party is entitled to a payment that references a dividend payment on an underlying security and the same party is obligated to make a payment that references a dividend payment on another underlying security pursuant to the potential section 871(m) transaction.

(B) *Example.* The following example illustrates the definitions in paragraph (a)(9) of this section:

Example. (i) Stock X and Stock Y are underlying securities. A and B enter into an NPC that entitles A to receive payments from B based on any appreciation in the value of Stock X and dividends paid on Stock X during the term of the contract and obligates A to make payments to B based on any depreciation in the value of Stock X during the term of the contract. In return, the NPC entitles B to receive payments from A based on any appreciation in the value of Stock Y and dividends paid on Stock Y during the term of the contract and obligates B to make payments to A based on any depreciation in the value of Stock Y during the term of the contract.

(ii) A is the long party with respect to Stock X, and the short party with respect to Stock Y. B is the long party with respect to Stock Y, and the short party with respect to Stock X.

(10) *Payment.* A *payment* has the meaning provided in paragraph (i) of this section.

(11) *Reference.* To *reference* means to be contingent upon or determined by reference to, directly or indirectly, whether in whole or in part.

(12) *Section 871(m) transaction or potential section 871(m) transaction.* A *section 871(m) transaction* is any securities lending or sale-repurchase transaction, specified NPC, or specified ELI. A *potential section 871(m) transaction* is any securities lending or sale-repurchase transaction, NPC, or ELI that references one or more underlying securities.

(13) *Securities lending or sale-repurchase transaction.* A *securities lending or sale-repurchase transaction* is any securities lending transaction, sale-repurchase transaction, or substantially similar transaction that references an underlying security. *Securities lending transaction* and *sale-repurchase trans-*

action have the same meaning as provided in § 1.861-3(a)(6).

(14) *Simple contracts and complex contracts—*(i) *Simple contract.* A *simple contract* is an NPC or ELI for which, with respect to each underlying security, all amounts to be paid or received on maturity, exercise, or any other payment determination date are calculated by reference to a single, fixed number of shares (as determined in paragraph (j)(3) of this section) of the underlying security, provided that the number of shares can be ascertained at the calculation time for the contract, and there is a single maturity or exercise date with respect to which all amounts (other than any upfront payment or any periodic payments) are required to be calculated with respect to the underlying security. For purposes of this section, a contract that provides an adjustment to the number of shares of the underlying security for a merger, stock split, cash dividend, or similar corporate action that affects all holders of the underlying securities proportionately will not cease to be treated as referencing a single, fixed number of shares solely as a result of that provision. A contract has a single exercise date even though it may be exercised by the holder at any time on or before the stated expiration of the contract. An NPC or ELI that includes a term that discontinuously increases or decreases the amount paid or received (such as a digital option), or that accelerates or extends the maturity is not a simple contract. A simple contract that is an NPC is a *simple NPC*. A simple contract that is an ELI is a *simple ELI*.

(ii) *Complex contract—*(A) *In general.* A *complex contract* is any NPC or ELI that is not a simple contract. A complex contract that is an NPC is a *complex NPC*. A complex contract that is an ELI is a *complex ELI*.

(B) *Example.* An ELI entitles the long party to a return equal to 200 percent of the appreciation on 100 shares of Stock X, and obligates the long party to pay an amount equal to the actual depreciation on 100 shares of Stock X. Pursuant to paragraph (j)(3) of the section, the ELI references 200 shares when Stock X appreciates, but only 100

shares when Stock X depreciates. Because the ELI does not provide the long party with an amount that is calculated by reference to a single, fixed number of shares of Stock X on the maturity date that can be ascertained at the calculation time, it is not a simple ELI. More specifically, upon maturity the ELI will either entitle the long party to receive a payment that is, in substance, measured by reference to 200 shares of stock or obligate the long party to make a payment measured by reference to 100 shares of stock. The ELI is a complex ELI because it is not a simple ELI.

(15) *Underlying security.* An *underlying security* is any interest in an entity if that interest could give rise to a U.S. source dividend pursuant to § 1.861-3, where applicable taking into account paragraph (m) of this section. Except as provided in paragraph (l) of this section, if a potential section 871(m) transaction references an interest in more than one entity described in the preceding sentence or different interests in the same entity, each referenced interest is a separate underlying security for purposes of applying the rules of this section.

(b) *Source of a dividend equivalent.* A dividend equivalent is treated as a dividend from sources within the United States for purposes of sections 871(a), 881, 892, 894, and 4948(a), and chapters 3 and 4 of subtitle A of the Internal Revenue Code.

(c) *Dividend equivalent*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, *dividend equivalent* means—

(i) Any payment that references a dividend from an underlying security pursuant to a securities lending or sale-repurchase transaction;

(ii) Any payment that references a dividend from an underlying security pursuant to a specified NPC described in paragraph (d) of this section;

(iii) Any payment that references a dividend from an underlying security pursuant to a specified ELI described in paragraph (e) of this section; and

(iv) Any other substantially similar payment as described in paragraph (f) of this section.

(2) *Exceptions*—(i) *Not a dividend.* A payment that references a distribution

with respect to an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to section 871(a) or section 881 if the long party owned the underlying security. For example, if an NPC references stock in a regulated investment company that pays a dividend that includes a capital gains dividend described in section 852(b)(3)(C) that would not be subject to tax under section 871(a) or section 881 if paid directly to the long party, then an NPC payment is not a dividend equivalent to the extent that it is determined by reference to the capital gains dividend.

(ii) *Section 305 coordination.* A dividend equivalent received by a long party, who is a shareholder as defined in § 1.305-1(d) of an instrument that gives rise to a dividend pursuant to sections 305(b) and (c) (including a debt instrument that is convertible into shares of stock and stock that is convertible into shares of another class of stock) that is also a section 871(m) transaction, is reduced by any amount treated as a dividend by sections 305(b) and (c) to the long party. For other section 871(m) transactions that reference an underlying security that is an instrument treated as paying a dividend pursuant to sections 305(b) and (c) and for which the long party is not a shareholder as defined in § 1.305-1(d), the dividend equivalent received by the long party with respect to the section 871(m) transaction includes (and is not reduced by) any amount treated as a dividend pursuant to sections 305(b) and (c).

(iii) *Due bills.* A dividend equivalent does not include a payment made pursuant to a due bill arising from the actions of a securities exchange that apply to all transactions in the stock with respect to the dividend. For purposes of this section, a stock will be considered to trade with a due bill only when the relevant securities exchange has set an ex-dividend date with respect to a dividend that occurs after the record date.

(iv) *Payments made pursuant to annuity, endowment, and life insurance contracts*—(A) *Insurance contracts issued by domestic insurance companies.* A payment made pursuant to a contract that

is an annuity, endowment, or life insurance contract issued by a domestic corporation (including its foreign or U.S. possession branch) that is a life insurance company described in section 816(a) does not include a dividend equivalent if the payment is subject to tax under section 871(a) or section 881.

(B) *Insurance contracts issued by foreign insurance companies.* A payment does not include a dividend equivalent if it is made pursuant to a contract that is an annuity, endowment, or life insurance contract issued by a foreign corporation that would be subject to tax under subchapter L if it were a domestic corporation.

(C) *Insurance contracts held by foreign insurance companies.* A payment made pursuant to a policy of insurance (including a policy of reinsurance) does not include a dividend equivalent if it is made to a foreign corporation that would be subject to tax under subchapter L if it were a domestic corporation.

(v) *Certain payments pursuant to employee compensation arrangements.* A dividend equivalent does not include the portion of equity-based compensation for personal services of a non-resident alien individual that is—

(A) Wages subject to withholding under section 3402 and the regulations under that section;

(B) Excluded from the definition of wages under § 1.3401(a)(6)-1; or

(C) Exempt from withholding under § 1.1441-4(b).

(d) *Specified NPCs*—(1) *Specified NPCs entered into before January 1, 2017*—(i) *In general.* For payments made after March 18, 2012, and before January 1, 2017, a specified NPC is any NPC if—

(A) In connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract;

(B) In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;

(C) The underlying security is not readily tradable on an established securities market; or

(D) In connection with entering into the contract, the underlying security is posted as collateral by any short party

to the contract with any long party to the contract.

(ii) *Specified NPC status as of January 1, 2017.* An NPC that is treated as a specified NPC pursuant to paragraph (d)(1)(i) of this section will remain a specified NPC on or after January 1, 2017.

(2) *Specified NPCs on or after January 1, 2017*—(i) *Simple NPCs.* A simple NPC that has a delta of 0.8 or greater with respect to an underlying security at the calculation time for the NPC is a specified NPC.

(ii) *Complex NPCs.* A complex NPC that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security at the calculation time for the NPC is a specified NPC.

(e) *Specified ELIs*—(1) *Simple ELIs.* A simple ELI that has a delta of 0.8 or greater with respect to an underlying security at the calculation time for the ELI is a specified ELI.

(2) *Complex ELIs.* A complex ELI that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security at the calculation time for the ELI is a specified ELI.

(f) *Other substantially similar payments.* For purposes of this section, any payment made in satisfaction of a tax liability of the long party with respect to a dividend equivalent by a withholding agent is a dividend equivalent received by the long party. The amount of that dividend equivalent constitutes additional income to the payee to the extent provided in § 1.1441-3(f)(1).

(g) *Delta*—(1) *In general.* Delta is the ratio of the change in the fair market value of an NPC or ELI to a small change in the fair market value of the number of shares of the underlying security (as determined under paragraph (j)(3) of this section) referenced by the NPC or ELI. If an NPC or ELI contains more than one reference to a single underlying security, all references to that underlying security are taken into account in determining the delta with respect to that underlying security. If an NPC or ELI references more than one underlying security or other property, the delta with respect to each underlying security must be determined without taking into account any other

underlying security or property. The delta of an equity derivative that is embedded in a debt instrument or other derivative is determined without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. Thus, for example, the delta of an option embedded in a convertible note is determined without regard to the debt component of the convertible note. For purposes of this section, delta must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of this section.

(2) *Time for determining delta*—(i) *In general.* Except as provided in paragraph (g)(4) of this section, the delta of a potential section 871(m) transaction is determined at the calculation time for the potential section 871(m) transaction.

(ii) *Calculation time.* The calculation time for a potential section 871(m) transaction is the earlier of when the potential section 871(m) transaction is priced and when the potential section 871(m) transaction is issued. Notwithstanding the preceding sentence, if the pricing time is more than 14 calendar days before the potential section 871(m) transaction is issued, the calculation time is when the potential section 871(m) transaction is issued.

(iii) *Pricing time.* A potential section 871(m) transaction is priced when all material economic terms for the transaction have been agreed upon, including the price at which the transaction is sold.

(3) *Simplified delta calculation for certain simple contracts that reference multiple underlying securities.* If an NPC or ELI references 10 or more underlying securities and an exchange-traded security (for example, an exchange-traded fund) is available that would fully hedge the NPC or ELI at the calculation time, the delta of the NPC or ELI may be calculated by determining the ratio of the change in the fair market value of the simple contract to a small change in the fair market value of the exchange-traded security. A delta determined under this paragraph (g)(3) must be used as the delta for each un-

derlying security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(ii) of this section.

(4) *Delta calculation for listed options*—

(i) *In general.* The delta of an option contract that is listed on a regulated exchange described in paragraph (g)(4)(ii) of this section is the delta of that option at the close of business on the business day before the date of issuance. On the date an option contract is listed for the first time, the delta is the delta of that option at the close of business on the date of issuance. Notwithstanding the preceding two sentences, the delta of a listed option that is also a customized option is determined under the rules of paragraphs (g)(2) and (g)(3) of this section.

(ii) *Regulated exchange.* For purposes of paragraph (g)(4)(i) of this section, a regulated exchange is any exchange that is either:

(A) Described in paragraph (1)(3)(vii) of this section; or

(B) [Reserved]. For further guidance, see § 1.871-15T(g)(4)(ii)(B).

(5) *Examples.* The following examples illustrate the rules of this paragraph (g). For purposes of these examples, Stock X and Stock Y are common stock of domestic corporations X and Y. LP is the long party to the transaction.

Example 1. Delta calculation for an NPC. The terms of an NPC require LP to pay the short party an amount equal to all of the depreciation in the value of 100 shares of Stock X and an interest-rate based return. In return, the NPC requires the short party to pay LP an amount equal to all of the appreciation in the value of 100 shares of Stock X and any dividends paid by X on those shares. The value of the NPC will change by \$1 for each \$0.01 change in the price of a share of Stock X. When LP entered into the NPC, Stock X had a fair market value of \$50 per share. The NPC therefore has a delta of 1.0 (\$1.00/(\$0.01 × 100)).

Example 2. Delta calculation for an option. LP purchases a call option that references 100 shares of Stock Y. At the time LP purchases the call option, the value of the option is expected to change by \$0.30 for a \$0.01 change in the price of a share of Stock Y. When LP purchases the option, Stock Y has a fair market value of \$100 per share. The call option has a delta of 0.3 (\$0.30/(\$0.01 × 100)).

(h) *Substantial equivalence test*—(1) *In general.* The substantial equivalence test described in this paragraph (h) applies to determine whether a complex contract is a section 871(m) transaction. The substantial equivalence test assesses whether a complex contract substantially replicates the economic performance of the underlying security by comparing, at various testing prices for the underlying security, the differences between the expected changes in value of that complex contract and its initial hedge with the differences between the expected changes in value of a simple contract benchmark (as described in paragraph (h)(2) of this section) and its initial hedge. If the complex contract contains more than one reference to a single underlying security, all references to that underlying security are taken into account for purposes of applying the substantial equivalence test with respect to that underlying security. With respect to an equity derivative that is embedded in a debt instrument or other derivative, the substantial equivalence test is applied to the complex contract without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. The complex contract is a section 871(m) transaction with respect to an underlying security if, for that underlying security, the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change in value of the simple contract benchmark and its initial hedge when the substantial equivalence test described in this paragraph (h) is calculated at the calculation time for the complex contract. To the extent that the steps of the substantial equivalence test set out in this paragraph (h) cannot be applied to a particular complex contract, a taxpayer must use the principles of the substantial equivalence test to reasonably determine whether the complex contract is a section 871(m) transaction with respect to each underlying security. For purposes of this section, the test must be applied and the inputs must be determined in a commercially reasonable manner. The term of the simple con-

tract benchmark must be, and the inputs must use, a reasonable time period, consistently applied (for example, in determining the standard deviation and probability). If a taxpayer calculates any relevant input for non-tax business purposes, that input ordinarily is the input used for purposes of this section.

(2) *Simple contract benchmark.* The simple contract benchmark is an actual or hypothetical simple contract that, at the calculation time for the complex contract, has a delta of 0.8, references the applicable underlying security referenced by the complex contract, and has terms that are consistent with all the material terms of the complex contract, including the maturity date. If an actual simple contract does not exist, the taxpayer must create a hypothetical simple contract. Depending on the complex contract, the simple contract benchmark might be, for example, a call option, a put option, or a collar.

(3) *Substantial equivalence.* A complex contract is a section 871(m) transaction with respect to an underlying security if the complex contract calculation described in paragraph (h)(4) of this section results in an amount that is equal to or less than the amount of the benchmark calculation described in paragraph (h)(5) of this section.

(4) *Complex contract calculation*—(i) *In general.* The complex contract calculation for each underlying security referenced by a potential section 871(m) transaction that is a complex contract is computed by:

(A) Determining the change in value (as described in paragraph (h)(4)(ii) of this section) of the complex contract with respect to the underlying security at each testing price (as described in paragraph (h)(4)(iii) of this section);

(B) Determining the change in value of the initial hedge for the complex contract at each testing price;

(C) Determining the absolute value of the difference between the change in value of the complex contract determined in paragraph (h)(4)(i)(A) of this section and the change in value of the initial hedge determined in paragraph (h)(4)(i)(B) of this section at each testing price;

(D) Determining the probability (as described in paragraph (h)(4)(iv) of this section) associated with each testing price;

(E) Multiplying the absolute value for each testing price determined in paragraph (h)(4)(i)(C) of this section by the corresponding probability for that testing price determined in paragraph (h)(4)(i)(D) of this section;

(F) Adding the product of each calculation determined in paragraph (h)(4)(i)(E) of this section; and

(G) Dividing the sum determined in paragraph (h)(4)(i)(F) of this section by the initial hedge for the complex contract.

(ii) *Determining the change in value.* The change in value of a complex contract is the difference between the value of the complex contract with respect to the underlying security at the calculation time for the complex contract and the value of the complex contract with respect to the underlying security if the price of the underlying security were equal to the testing price at the calculation time for the complex contract. The change in value of the initial hedge of a complex contract with respect to the underlying security is the difference between the value of the initial hedge at the calculation time for the complex contract and the value of the initial hedge if the price of the underlying security were equal to the testing price at the calculation time for the complex contract.

(iii) *Testing price.* The testing prices must include the prices of the underlying security if the price of the underlying security at the calculation time for the complex contract were alternatively increased by one standard deviation and decreased by one standard deviation, each of which is a separate testing price. In circumstances where using only two testing prices is reasonably likely to provide an inaccurate measure of substantial equivalence, a taxpayer must use additional testing prices as necessary to determine whether a complex contract satisfies the substantial equivalence test. If additional testing prices are used for the substantial equivalence test, the probabilities as described in paragraph (h)(4)(iv) of this section must be adjusted accordingly.

(iv) *Probability.* For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of an increase by one standard deviation is the measure of the likelihood that the price of the underlying security will increase by any amount from its price at the calculation time for the complex contract. For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of a decrease by one standard deviation is the measure of the likelihood that the price of the underlying security will decrease by any amount from its price at the calculation time for the complex contract.

(5) *Benchmark calculation.* The benchmark calculation with respect to each underlying security referenced by the potential section 871(m) transaction is determined by using the computation methodology described in paragraph (h)(4) of this section with respect to a simple contract benchmark for the underlying security.

(6) *Substantial equivalence calculation for certain complex contracts that reference multiple underlying securities.* If a complex contract references 10 or more underlying securities and an exchange-traded security (for example, an exchange-traded fund) is available that would fully hedge the complex contract at its calculation time, the substantial equivalence calculations for the complex contract may be calculated by treating the exchange-traded security as the underlying security. When the exchange-traded security is used for the substantial equivalence calculation pursuant to this paragraph (h)(6), the initial hedge is the number of shares of the exchange-traded security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(iii) of this section.

(7) *Example.* The following example illustrates the rules of paragraph (h) of this section. For purposes of this example, Stock X is common stock of domestic corporation X. FI is the financial institution that structures the transaction described in the example, and is the short party to the transaction. Investor is a nonresident alien individual.

Example. Complex contract that is not substantially equivalent. (i) FI issues an investment contract (the Contract) that has a stated maturity of one year, and Investor purchases the Contract from FI at issuance for \$10,000. At maturity, the Contract entitles Investor to a return of \$10,000 (i) plus 200 percent of any appreciation in Stock X above \$100 per share, capped at \$110, on 100 shares or (ii) minus 100 percent of any depreciation in Stock X below \$90 on 100 shares. At the calculation time for the Contract, the price of Stock X is \$100 per share. Thus, for example, Investor will receive \$11,000 if the price of Stock X is \$105 per share at maturity of the Contract, but Investor will receive \$9,000 if the price of Stock X is \$80 per share when the Contract matures. At issuance, FI acquires 64 shares of Stock X to fully hedge the Contract issued to Investor. The calculation time for this example is the issuance.

(ii) The Contract references an underlying security and is not an NPC, so it is classified as an ELI under paragraph (a)(4) of this section. At the calculation time for the Contract, the Contract does not provide for an amount paid at maturity that is calculated by reference to a single, fixed number of shares of Stock X. When the Contract matures, the amount paid is effectively calculated based on either 200 shares of Stock X (if the price of Stock X has appreciated up to \$110) or 100 shares of Stock X (if the price of Stock X has declined below \$90). Consequently, the Contract is a complex contract described in paragraph (a)(14) of this section.

(iii) Because it is a complex ELI, FI applies the substantial equivalence test described in paragraph (h) of this section to determine whether the Contract is a specified ELI. FI determines that the price of Stock X would be \$120 if the price of Stock X were increased by one standard deviation, and \$79 if the price of Stock X were decreased by one standard deviation. Based on these results, FI next determines the change in value of the Contract to be \$2000 at the testing price that represents an increase by one standard deviation (\$12,000 testing price minus \$10,000 issue price) and a negative \$1,100 at the testing price that represents a decrease by one standard deviation (\$10,000 issue price minus \$8,900 testing price). FI performs the same calculations for the 64 shares of Stock X that constitute the initial hedge, determining that the change in value of the initial hedge is \$1,280 at the testing price that represents an increase by one standard deviation (\$6,400 at issuance compared to \$7,680 at the testing price) and negative \$1,344 at the testing price that represents a decrease by one standard deviation (\$6,400 at issuance compared to \$5,056 at the testing price).

(iv) FI then determines the absolute value of the difference between the change in value of the initial hedge and the Contract at the

testing price that represents an increase by one standard deviation and a decrease by one standard deviation. Increased by one standard deviation, the absolute value of the difference is \$720 (\$2,000-\$1,280); decreased by one standard deviation, the absolute value of the difference is \$244 (negative \$1,100 minus negative \$1,344). FI determines that there is a 52% chance that the price of Stock X will have increased in value when the Contract matures and a 48% chance that the price of Stock X will have decreased in value at that time. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents an increase by one standard deviation by 52%, which equals \$374.40. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents a decrease by one standard deviation by 48%, which equals \$117.12. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the transaction calculation is 7.68 ((\$374.40 plus \$117.12) divided by 64).

(v) FI then performs the same calculation with respect to the simple contract benchmark, which is a one-year call option that references one share of Stock X, settles on the same date as the Contract, and has a delta of 0.8. The one-year call option has a strike price of \$79 and has a cost (the purchase premium) of \$22. The initial hedge for the one-year call option is 0.8 shares of Stock X.

(vi) FI first determines that the change in value of the simple contract benchmark is \$19.05 if the testing price is increased by one standard deviation (\$22.00 at issuance to \$41.05 at the testing price) and negative \$20.95 if the testing price is decreased by one standard deviation (\$22.00 at issuance to \$1.05 at the testing price). Second, FI determines that the change in value of the initial hedge is \$16.00 at the testing price that represents an increase by one standard deviation (\$80 at issuance to \$96 at the testing price) and negative \$16.80 at the testing price that represents a decrease by one standard deviation (\$80.00 at issuance to \$63.20 at the testing price).

(vii) FI determines the absolute value of the difference between the change in value of the initial hedge and the one-year call option at the testing price that represents an increase by one standard deviation is \$3.05 (\$16.00 minus \$19.05). FI next determines the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation is \$4.15 (negative \$16.80 minus negative \$20.95). FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing

price that represents an increase by one standard deviation by 52%, which equals \$1.586. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation by 48%, which equals \$1.992. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the benchmark calculation is 4.473 ((1.586 plus 1.992) divided by .8).

(viii) FI concludes that the Contract is not a section 871(m) transaction because the transaction calculation of 7.68 exceeds the benchmark calculation of 4.473.

(i) *Payment of a dividend equivalent—*

(1) *Payments determined on gross basis.* For purposes of this section, a payment includes any gross amount that references a dividend and that is used in computing any net amount transferred to or from the long party even if the long party makes a net payment to the short party or no amount is paid because the net amount is zero.

(2) *Actual and estimated dividends—(i) In general.* A payment includes any amount that references an actual or estimated dividend, whether the reference is explicit or implicit. If a potential section 871(m) transaction provides for a payment based on an estimated dividend that adjusts to account for the amount of an actual dividend paid, the payment is treated as referencing the actual dividend amount and not an estimated dividend amount.

(ii) *Implicit dividends.* A payment includes an actual or estimated dividend that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction, including interest rate, notional amount, purchase price, premium, upfront payment, strike price, or any other amount paid or received pursuant to the potential section 871(m) transaction.

(iii) *Actual dividend presumption.* A short party to a section 871(m) transaction is treated as paying a per-share dividend amount equal to the actual dividend amount unless the short party to the section 871(m) transaction identifies a reasonable estimated dividend amount in writing at the calculation time. For this purpose, a reasonable estimated dividend amount stated in an offering document or the documents governing the terms at the calculation

time will establish the estimated dividend amount. To qualify as an estimated dividend amount, the written estimated dividend amount must separately state the amount estimated for each anticipated dividend or state a formula that allows each dividend to be determined. If an underlying security is not expected to have a dividend, a reasonable estimate of the dividend amount may be zero.

(iv) *Additions to estimated payments.* If a section 871(m) transaction provides for any payment in addition to an estimated dividend and that additional payment is determined by reference to a dividend (for example, a special dividend), both the estimated dividend and the additional payment are used to determine the per-share dividend amount.

(3) *Dividends for certain baskets—(i) In general.* If a section 871(m) transaction references long positions in more than 25 underlying securities, the short party may treat the dividends with respect to the referenced underlying securities as paid at the end of the applicable calendar quarter to compute the per-share dividend amount.

(ii) *Publicly available dividend amount.* For purposes of paragraph (i)(3)(i) of this section, if a section 871(m) transaction references the same underlying securities as a security (for example, stock in an exchange-traded fund) or index for which there is a publicly available quarterly dividend amount, the publicly available dividend amount may be used to determine the per-share dividend amount for the section 871(m) transaction with any adjustment for special dividends.

(iii) *Dividend amount for a section 871(m) transaction using the simplified delta calculation.* When the delta of a section 871(m) transaction is determined under paragraph (g)(3) of this section, the per-share dividend amount for that section 871(m) transaction must be determined using the dividend amount for the exchange-traded security that would fully hedge the section 871(m) transaction (whether or not the exchange-traded security is actually acquired).

(4) *Examples.* The following examples illustrate the rules of this paragraph (i). For purposes of these examples,

Stock X is common stock of Corporation X, a domestic corporation, that historically pays quarterly dividends on Stock X. The parties anticipate that Corporation X will continue to pay quarterly dividends.

Example 1. Forward contract to purchase domestic stock. (i) When Stock X is trading at \$50 per share, Foreign Investor enters into a forward contract to purchase 100 shares of Stock X in one year. Reasonable estimates of the quarterly dividend are specified in the transaction documents. The price in the forward contract is determined by multiplying the number of shares referenced in the contract by the current price of the shares and an interest rate, and subtracting the value of any dividends expected to be paid during the term of the contract. Assuming that the forward contract is priced using an interest rate of 4 percent and total estimated dividends with a future value of \$1 per share during the term of the forward contract, the purchase price set in the forward contract is \$5,100 (100 shares \times \$50 per share \times 1.04 - (\$1 \times 100)).

(ii) Subject to paragraph (i)(2)(iv) of this section, the estimated dividend amounts are the per-share dividend amounts because the estimates are reasonable and specified in accordance with paragraph (i)(2)(iii) of this section. The estimated per-share dividend amounts are dividend equivalents for purposes of this section.

Example 2. Price return only swap contract.

(i) Foreign Investor enters into a price return swap contract that entitles Foreign Investor to receive payments based on the appreciation in the value of 100 shares of Stock X and requires Foreign Investor to pay an amount based on LIBOR plus any depreciation in the value of Stock X. The swap contract neither explicitly entitles Foreign Investor to payments based on dividends paid on Stock X during the term of the contract nor references an estimated dividend amount. The LIBOR rate in the swap contract, however, is reduced to reflect expected annual dividends on Stock X.

(ii) Because the LIBOR leg of the swap contract is reduced to reflect estimated dividends and the estimated dividend amounts are not specified, Foreign Investor is treated as receiving the actual dividend amounts are in accordance with paragraph (i)(2) of this section. The actual per-share dividend amounts are dividend equivalents for purposes of this section.

(j) *Amount of dividend equivalent—* (1) *Calculation of the amount of a dividend equivalent.* The long party is liable for tax on any dividend equivalents required to be determined pursuant to paragraph (j)(2) of this section only

with respect to dividend equivalents that arise while the long party is a party to the transaction. The amount of any dividend equivalent is determined as follows:

(i) *Securities lending or sale-repurchase transactions.* For a securities lending or sale-repurchase transaction, the amount of the dividend equivalent for each dividend on an underlying security equals the amount of the actual per-share dividend paid on the underlying security multiplied by the number of shares of the underlying security.

(ii) *Simple contracts.* For a simple contract that is a section 871(m) transaction, the amount of the dividend equivalent for each dividend on an underlying security equals:

(A) The per-share dividend amount (as determined under either paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The number of shares of the underlying security multiplied by;

(C) The delta of the section 871(m) transaction with respect to the underlying security.

(iii) *Complex contracts.* For a complex contract that is a section 871(m) transaction, the amount of the dividend equivalent for each dividend on an underlying security equals:

(A) The per-share dividend amount (as determined under paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The initial hedge for the underlying security.

(iv) *Other substantially similar payments.* In addition to any amount determined pursuant to paragraph (j)(1)(i), (ii), or (iii), the amount of a dividend equivalent includes the amount of any payment described in paragraph (f) of this section.

(2) *Time for determining the amount of a dividend equivalent.* The amount of a dividend equivalent is determined on the earlier of the date that is the record date of the dividend and the day prior to the ex-dividend date with respect to the dividend. For example, if a specified NPC provides for a payment at settlement that takes into account an earlier dividend payment, the amount of the dividend equivalent is

determined on the earlier of the record date or the day prior to the ex-dividend date for that dividend.

(3) *Number of shares.* The number of shares of an underlying security generally is the number of shares of the underlying security stated in the contract. If the transaction modifies that number by a factor or fraction or otherwise alters the amount of any payment, the number of shares is adjusted to take into account the factor, fraction, or other modification. For example, in a transaction in which the long party receives or makes payments based on 200 percent of the appreciation or depreciation (as applicable) of 100 shares of stock, the number of shares of the underlying security is 200 shares of the stock.

(4) *Taxable year of a dividend equivalent.* A long party is liable for tax on a dividend equivalent in the year the dividend equivalent is subject to withholding pursuant to § 1.1441-2(e)(7). Notwithstanding the preceding sentence, a long party that is a qualified derivatives dealer is liable for tax on a dividend equivalent when the applicable dividend on the underlying security would be subject to withholding pursuant to § 1.1441-2(e)(4). The amount of the long party's tax liability, however, is determined by reference to the amount that would have been due at the time the dividend equivalent amount is determined pursuant to paragraph (j)(2) of this section based on the beneficial owners at that time (for example, based on the tax rate at that time, whether the long party qualified for a treaty benefit at that time, and in the case of a partnership, based on the partners at that time).

(k) *Limitation on the treatment of certain corporate acquisitions as section 871(m) transactions.* A potential section 871(m) transaction is not a section 871(m) transaction with respect to an underlying security if the transaction obligates the long party to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the long party) are obligated to acquire underlying securities representing more than 50 percent of the value of the entity issuing the underlying securities.

(1) *Rules relating to indices*—(1) *Purpose.* The purpose of this paragraph (1) is to provide a safe harbor for potential section 871(m) transactions that reference certain passive indices that are based on a diverse basket of publicly-traded securities and that are widely used by numerous market participants. Notwithstanding any other provision in this paragraph (1), an index is not a qualified index if treating the index as a qualified index would be contrary to the purpose described in this paragraph (1).

(2) *Qualified index not treated as an underlying security*—(i) *In general.* For purposes of this section, a qualified index is treated as a single security that is not an underlying security. The determination of whether an index referenced in a potential section 871(m) transaction is a qualified index is made at the calculation time for the transaction based on whether the index is a qualified index on the first business day of the calendar year containing the calculation time.

(ii) *Rule for the first year of an index.* In the case of an index that was not in existence on the first business day of the calendar year containing the calculation time for the transaction, paragraph (1)(2) of this section is applied by testing the index on the first business day it is created, and the dividend yield calculation required by paragraph (1)(3)(vi) of this section is determined by using the dividend yield that the index would have had in the immediately preceding year if it had the same components throughout that year that it has on the day it is created.

(3) *Qualified index.* A *qualified index* means an index that—

(i) References 25 or more component securities (whether or not the security is an underlying security);

(ii) Except as provided in paragraph (1)(6)(ii) of this section, references only long positions in component securities;

(iii) References no component underlying security that represents more than 15 percent of the weighting of the component securities in the index;

(iv) References no five or fewer component underlying securities that together represent more than 40 percent of the weighting of the component securities in the index;

(v) Is modified or rebalanced only according to publicly stated, predefined criteria, which may require interpretation by the index provider or a board or committee responsible for maintaining the index;

(vi) Did not provide an annual dividend yield in the immediately preceding calendar year from component underlying securities that is greater than 1.5 times the annual dividend yield of the S&P 500 Index as reported for the immediately preceding calendar year; and

(vii) Is traded through futures contracts or option contracts (regardless of whether the contracts provide price only or total return exposure to the index or provide for dividend reinvestment in the index) on—

(A) A national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission; or

(B) A foreign exchange or board of trade that is a qualified board or exchange as determined by the Secretary pursuant to section 1256(g)(7)(C) or that has a staff no action letter from the CFTC permitting direct access from the United States that is effective on the applicable testing date, provided that the referenced component underlying securities, in the aggregate, comprise less than 50 percent of the weighting of the component securities in the index.

(4) *Safe harbor for certain indices that reference assets other than underlying securities.* Notwithstanding paragraph (1)(3) of this section, an index is a qualified index if the index is widely traded, the referenced component underlying securities in the aggregate comprise 10 percent or less of the weighting of the component securities in the index, and the index was not formed or availed of with a principal purpose of avoiding U.S. withholding tax.

(5) *Weighting of component securities.* For purposes of this paragraph (1), the weighting of a component security of an index is the percentage of the index's value represented, or accounted for, by the component security.

(6) *Transactions that reference a qualified index and one or more component securities or indices—(i) In general.* When a potential section 871(m) transaction references a qualified index and one or more component securities or other indices, the qualified index remains a qualified index only if the potential section 871(m) transaction does not reference a short position in any referenced component security of the qualified index, other than a short position with respect to the entire qualified index (for example, a cap or floor) or a de minimis short position described in paragraph (1)(6)(ii) of this section. If, in connection with a potential section 871(m) transaction that references a qualified index, a taxpayer (or a related person within the meaning of section 267(b) or section 707(b)) enters into one or more transactions that reduce exposure to any referenced component security of the index, other than transactions that reduce exposure to the entire index, then the potential section 871(m) transaction is not treated as referencing a qualified index.

(ii) *Safe harbor for de minimis short positions.* Notwithstanding paragraphs (1)(3)(ii) and (1)(6)(i) of this section, an index may be a qualified index if the short position (whether part of the index or entered into separately by the taxpayer or related person within the meaning of section 267(b) or section 707(b)) reduces exposure to referenced component securities of a qualified index (excluding any short positions with respect to the entire qualified index) by five percent or less of the value of the long positions in component securities in the qualified index.

(7) *Transactions that indirectly reference a qualified index.* If a potential section 871(m) transaction references an exchange-traded fund that tracks a qualified index, the potential section 871(m) transaction will be treated as referencing a qualified index.

(m) *Rules relating to derivatives that reference partnerships—(1) In general.* When a potential section 871(m) transaction references a partnership interest, the assets of the partnership will be treated as referenced by the potential section 871(m) transaction only if the partnership carries on a trade or

business of dealing or trading in securities, holds significant investments in securities (either of which is a covered partnership), or directly or indirectly holds an interest in a lower-tier partnership that is a covered partnership. For purposes of this section, if a covered partnership directly or indirectly holds assets that are underlying securities or potential section 871(m) transactions, any potential section 871(m) transaction that references an interest in the covered partnership is treated as referencing the shares of the underlying securities, including underlying securities of potential section 871(m) transactions, directly or indirectly allocable to that partnership interest. For purposes of this paragraph (m), a security is defined in section 475(c).

(2) *Significant investments in securities*—(i) *In general.* For purposes of this paragraph (m), a partnership holds significant investments in securities if either—

(A) 25 percent or more of the value of the partnership's assets consist of underlying securities or potential section 871(m) transactions; or

(B) The value of the underlying securities or potential section 871(m) transactions equals or exceeds \$25 million.

(ii) *Determining the value of the partnership's assets.* For purposes of this paragraph (m)(2)(i) of this section, the value of a partnership's assets is determined at the calculation time for the potential section 871(m) transaction referencing that partnership interest based on the value of the assets held by the partnership on the last day of the partnership's prior taxable year unless the long party or the short party has actual knowledge that a subsequent transaction has caused the partnership to cross either of the thresholds described in paragraph (m)(2)(i). The value of a partnership's assets is equal to their fair market value, except that the value of any NPC, futures contract, forward contract, option, and any similar financial instrument held by the partnership is deemed to be the value of the notional securities referenced by the transaction.

(n) *Combined transactions*—(1) *In general.* For purposes of determining whether a potential section 871(m) transaction is a section 871(m) trans-

action, two or more potential section 871(m) transactions are treated as a single transaction with respect to an underlying security when—

(i) A person (or a related person within the meaning of section 267(b) or section 707(b)) is the long party with respect to the underlying security for each potential section 871(m) transaction;

(ii) The potential section 871(m) transactions reference the same underlying security;

(iii) The potential section 871(m) transactions, when combined, replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction; and

(iv) The potential section 871(m) transactions are entered into in connection with each other (regardless of whether the transactions are entered into simultaneously or with the same counterparty).

(2) *Section 871(m) transactions.* If a potential section 871(m) transaction is a section 871(m) transaction, either by itself or as a result of a combination with one or more other potential section 871(m) transactions, it does not cease to be a section 871(m) transaction as a result of applying paragraph (n) of this section or disposing of one or more of the potential section 871(m) transaction with which it is combined.

(3) *Short party presumptions regarding combined transactions*—(i) *In general.* If a short party relies on the presumption provided in paragraph (n)(3)(ii) of this section or in paragraph (n)(3)(iii) of this section, the short party is not required to treat those potential section 871(m) transactions as part of a single transaction pursuant to paragraph (n)(1) of this section.

(ii) *Transactions in separate accounts.* A short party that is a broker may presume that transactions are not entered into in connection with each other for purposes of paragraph (n)(1) of this section if a long party holds or reflects the transactions in separate accounts maintained by the short party, unless the short party has actual knowledge that the transactions held or reflected in separate accounts by the long party were entered into in connection with each other or that separate accounts

were created or used to avoid section 871(m).

(iii) *Transactions separated by at least two business days.* A short party that is a broker may presume that transactions entered into two or more business days apart are not entered into in connection with each other for purposes of paragraph (n)(1) of this section unless the short party has actual knowledge that the transactions were entered into in connection with each other.

(4) *Presumptions Commissioner will apply to long party*—(i) *Transactions in separate trading books.* The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party properly reflected those transactions on separate trading books. The Commissioner may rebut this presumption with facts and circumstances showing that transactions reflected on separate trading books were entered into in connection with each other or that separate trading books were created or used to avoid section 871(m).

(ii) *Transactions separated by at least two days.* The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party entered into the transactions two or more business days apart. The Commissioner may rebut this presumption with facts and circumstances showing that the transactions entered into two or more business days apart were entered into in connection with each other.

(iii) *Transactions separated by fewer than two days and reflected in the same trading book.* The Commissioner will presume that transactions that are entered into fewer than two business days apart and reflected on the same trading book are entered into in connection with each other. A long party can rebut this presumption with facts and circumstances showing that the transactions were not entered into in connection with each other.

(5) *Rules of application*—(i) *Two business days rule.* For the purpose of determining the number of business days be-

tween transactions, the short party may, and the Commissioner will, assume that all transactions are entered into at 4:00 p.m. on the date the transaction becomes effective in the jurisdiction of the long party.

(ii) *No long party presumptions.* Notwithstanding the presumptions described in paragraphs (n)(3) and (n)(4) of this section, the long party must treat two or more transactions as combined transactions if the transactions are described in paragraph (n)(1) of section.

(6) *Ordering rule for transactions entered into in connection with each other.* If a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), a short party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security. Thus, for example, if a taxpayer has sold one at-the-money put and purchased two at-the-money calls, each with respect to 100 shares of the same underlying security, the put and one call are combined. Similarly, a purchased call on 100 shares and a sold put on 200 shares of the same underlying security can be combined for 100 shares with 100 shares of the put remaining separate. The two calls are not combined because they do not provide the long party with economic exposure to depreciation in the underlying security. Similarly, if a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), but have not been combined by a short party, the long party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security.

(7) *More than one underlying security referenced.* If potential section 871(m) transactions reference more than one underlying security, paragraph (n)(1) of this section applies separately with respect to each underlying security.

(o) *Anti-abuse rule.* If a taxpayer directly or through the use of a related

person within the meaning of section 267(b) or section 707(b)) acquires (whether by entering into, purchasing, accepting by transfer, by exchange, or by conversion, or otherwise acquiring) or disposes of (whether by sale, offset, exercise, termination, expiration, maturity, or other means) a transaction or transactions with a principal purpose of avoiding the application of this section, the Commissioner may treat any payment (as described in paragraph (i) of this section) made with respect to that transaction or transactions as a dividend equivalent to the extent necessary to prevent the avoidance of this section. Therefore, notwithstanding any other provision of this section, the Commissioner may, for example, adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, change the maturity, adjust the timing of payments, treat a transaction that references a partnership interest as referencing the assets of the partnership, combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions, or otherwise depart from the rules of this section as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). When a withholding agent knows that the taxpayer acquired or disposed of a transaction or transactions with a principal purpose of avoiding the application of this section and the Commissioner treats a payment made with respect to any transaction as a dividend equivalent, the withholding agent may be liable for any tax pursuant to section 1461.

(p) *Information required to be reported regarding a potential section 871(m) transaction—(1) Responsible party—(i) In general.* If a broker or dealer is a party to a potential section 871(m) transaction with a counterparty or customer that is not a broker or dealer, the broker or dealer is required to determine whether the potential section 871(m) transaction is a section 871(m) transaction. If both parties to a potential section

871(m) transaction are brokers or dealers, or neither party to a potential section 871(m) transaction is a broker or dealer, the short party must determine whether the potential section 871(m) transaction is a section 871(m) transaction.

(ii) [Reserved]. For further guidance, see § 1.871-15T(p)(1)(ii).

(iii) [Reserved]. For further guidance, see § 1.871-15T(p)(1)(iii).

(iv) [Reserved]. For further guidance, see § 1.871-15T(p)(1)(iv).

(v) *Obligations of the responsible party.* The party to the transaction that is required to determine whether a transaction is a section 871(m) transaction must also determine and report to the counterparty or customer the timing and amount of any dividend equivalent (as described in paragraphs (i) and (j) of this section). Except as otherwise provided in paragraph (n)(3) of this section, the party required to make the determinations described in this paragraph is required to exercise reasonable diligence to determine whether a transaction is a section 871(m) transaction, the amount of any dividend equivalents, and any other information necessary to apply the rules of this section. The information must be provided in the manner prescribed in paragraphs (p)(2) and (p)(3) of this section. The determinations required by paragraph (p) of this section are binding on the parties to the potential section 871(m) transaction and on any person who is a withholding agent with respect to the potential section 871(m) transaction unless the person knows or has reason to know that the information received is incorrect. The determinations are not binding on the Commissioner.

(2) *Reporting requirements.* For rules regarding the reporting requirements of withholding agents with respect to dividend equivalents described in this section, see §§ 1.1461-1(b) and (c) and 1.1474-1(c) and (d).

(3) *Additional information available to a party to a potential section 871(m) transaction—(i) In general.* Upon request by any person described in paragraph (p)(3)(ii) of this section, the party required to report information pursuant to paragraph (p)(1) of this section must provide the requester with information regarding the amount of each dividend

equivalent, the delta of the potential section 871(m) transaction, the amount of any tax withheld and deposited, the estimated dividend amount if specified in accordance with paragraph (i)(2)(iii) of this section, the identity of any transactions combined pursuant to paragraph (n) of this section, and any other information necessary to apply the rules of this section. The information requested must be provided within a reasonable time, not to exceed 10 business days, and communicated in one or more of the following ways:

(A) By telephone, and confirmed in writing;

(B) By written statement sent by first class mail to the address provided by the requesting party;

(C) By electronic publication available to all persons entitled to request information; or

(D) By any other method agreed to by the parties, and confirmed in writing.

(ii) *Persons entitled to request information.* Any party to the transaction described in paragraph (a)(9) of this section may request the information specified in paragraph (p) of this section with respect to a potential section 871(m) transaction from the party required by paragraph (p)(3)(i) of this section to provide the information.

(iii) *Reliance on information received.* A person described in paragraph (p)(1) or (p)(3)(ii) of this section that receives information described in paragraph (p)(1) or (p)(3)(i) of this section may rely on that information to provide information to any other person unless the recipient knows or has reason to know that the information received is incorrect. When the recipient knows or has reason to know that the information received is incorrect, the recipient must make a reasonable effort to determine and provide the information described in paragraph (p)(1) or (p)(3)(i) of this section to any person described in paragraph (p)(1) or (p)(3)(ii) of this section that requests information from the recipient.

(4) *Recordkeeping rules—(i) In general.* For rules regarding recordkeeping requirements sufficient to establish whether a transaction is a section 871(m) transaction and whether a payment is a dividend equivalent and the

amount of gross income treated as a dividend equivalent, see § 1.6001-1.

(ii) *Records sufficient to establish whether a transaction is a section 871(m) transaction and any dividend equivalent amount.* Any person required to retain records must keep sufficient information to establish whether a transaction is a section 871(m) transaction and the amount of a dividend equivalent (if any), including documentation and work papers supporting the delta calculation or the substantial equivalence test (including the number of shares of the initial hedge), as applicable, and written estimated dividends (if any). The records and documentation must be created substantially contemporaneously. A record will be considered to have been created substantially contemporaneously if it was created within 10 business days of the date containing the calculation time for the potential section 871(m) transaction.

(iii) *Recordkeeping required for certain options.* With respect to any option to which paragraph (g)(4) of this section applies, contemporaneous documentation is not required to be retained provided that there is a pre-existing documented methodology that is sufficient to permit the delta for the transaction to be verified at a later time.

(5) [Reserved]. For further guidance, see § 1.871-15T(p)(5).

(q) *Dividend and dividend equivalent payments to a qualified derivatives dealer—(1) In general.* Except as otherwise provided in this paragraph (q), a qualified derivatives dealer described in § 1.1441-1(e)(6) that receives a payment (within the meaning of paragraph (i) of this section) of a dividend equivalent in its equity derivatives dealer capacity will not be liable for tax under section 881 on that dividend equivalent, provided that the qualified derivatives dealer complies with its obligations under the qualified intermediary agreement described in §§ 1.1441-1(e)(5) and 1.1441-1(e)(6). A qualified derivatives dealer is liable for tax under section 881(a)(1) on its section 871(m) amount for each dividend on each underlying security. This tax liability is reduced (but not below zero) by the amount of tax paid by the qualified derivatives dealer under section 881(a)(1) on dividends it receives with respect to that

underlying security on that same dividend in its capacity as an equity derivatives dealer. In addition, a qualified derivatives dealer is liable for tax under section 881(a)(1) for all dividend equivalents it receives that are not received in its equity derivatives dealer capacity. A qualified derivatives dealer also is liable for tax under section 881(a)(1) for all dividends it receives, other than dividends received in 2017 in its equity derivatives dealer capacity. This paragraph does not apply for a qualified derivatives dealer that is a foreign branch of a United States financial institution (within the meaning of § 1.1471-5(e)).

(2) *Transactions on the books of an equity derivatives dealer.* Transactions properly reflected in a qualified derivatives dealer's equity derivatives dealer book are presumed to be held by the dealer in its equity derivatives dealer capacity for purposes of determining the qualified derivatives dealer's tax liability. For purposes of determining whether a dealer is acting in its equity derivatives dealer capacity, only the dealer's activities as an equity derivatives dealer are taken into account. Accordingly, for purposes of this paragraph (q), a dividend or dividend equivalent is treated as received by a qualified derivatives dealer acting in its non-equity derivatives dealer capacity if the dividend or dividend equivalent is received by a qualified derivatives dealer acting as a proprietary trader.

(3) *Section 871(m) amount.* For each dividend on each underlying security, the section 871(m) amount is the product of:

(i) The qualified derivatives dealer's net delta exposure to the underlying security for the applicable dividend, multiplied by;

(ii) The applicable dividend amount per share.

(4) *Net delta exposure.* The net delta exposure to an underlying security is the amount (measured in number of shares) by which (A) the aggregate number of shares of an underlying security that the qualified derivatives dealer has exposure to as a result of positions in the underlying security (including as a result of owning the underlying security) with values that move in the same direction as the un-

derlying security (the long positions) exceeds (B) the aggregate number of shares of an underlying security that the qualified derivatives dealer has exposure to as a result of positions in the underlying security with values that move in the opposite direction from the underlying security (the short positions). The net delta exposure calculation only includes long positions and short positions that the qualified derivatives dealer holds in its equity derivatives dealer capacity (as described in paragraph (q)(2) of this section). Any long positions or short positions that are treated as effectively connected with the qualified derivatives dealer's conduct of a trade or business in the United States for U.S. federal income tax purposes are excluded from the net delta exposure computation. The net delta exposure to an underlying security is determined at the end of the day on the date provided in § 1.871-15(j)(2) for the applicable dividend. For purposes of this calculation, net delta must be determined in a commercially reasonable manner. If a qualified derivatives dealer calculates net delta for non-tax business purposes, the net delta ordinary will be the delta used for that purpose, subject to the modifications required by this definition. Each qualified derivatives dealer must determine its net delta exposure separately only taking into account transactions that are recognized and are attributable to that qualified derivatives dealer for U.S. federal income tax purposes.

(5) *Examples.* The following examples illustrate the rules of this paragraph (q):

Example 1. Forward contract entered into by a foreign equity derivatives dealer. (i) *Facts.* FB is a foreign bank that is a qualified intermediary that acts as a qualified derivatives dealer. On April 1, Year 1, FB enters into a cash settled forward contract initiated by a foreign customer (Customer) that entitles Customer to receive from FB all of the appreciation and dividends on 100 shares of Stock X, and obligates Customer to pay FB any depreciation on 100 shares of Stock X, at the end of three years. FB hedges the forward contract by entering into a total return swap contract with a domestic broker (U.S. Broker) and maintains the swap contract as a hedge for the duration of the forward contract. The swap contract entitles FB to receive an amount equal to all of the dividends

on 100 shares of Stock X and obligates FB to pay an amount referenced to a floating interest rate each quarter, and also entitles FB to receive from or pay to U.S. Broker, as the case may be, the difference between the value of 100 shares of Stock X at the inception of the swap and the value of 100 shares of Stock X at the end of 3 years. Stock X pays a quarterly dividend of \$0.25 per share. At the end of the day on the date provided in paragraph (j)(2) of this section for the dividend, FB owns the forward contract and total return swap; FB does not own any shares of Stock X or any other transactions that reference Stock X. FB provides valid documentation to U.S. Broker that FB will receive payments under the swap contract in its capacity as a qualified derivatives dealer, and FB contemporaneously enters both the swap contract with U.S. Broker and the forward contract with Customer on its equity derivatives dealer books.

(ii) *Application of rules.* At the end of the day on the date provided in paragraph (j)(2) of this section for the dividend, FB is a long party on a delta one contract (the total return swap) and a short party on a delta one contract (the forward contract with Customer). Pursuant to § 1.1441-1(b)(4)(xxii), U.S. Broker is not obligated to withhold on the dividend equivalent payments to FB on the swap contract that are referenced to Stock X dividends because U.S. Broker has received valid documentation that it may rely upon to treat the payment as made to FB acting as a qualified derivatives dealer. Pursuant to paragraph (q)(1) of this section, FB is not liable for tax under sections 871(m) and 881 on the payments it receives from U.S. Broker referenced to Stock X dividends because FB's net delta exposure with respect to 100 shares of Stock X is zero at the end of the day on the date provided in paragraph (j)(2) of this section for the dividend. The net delta exposure is zero because the taxpayer has 100 shares of Stock X long position exposure as a result of the total return swap that is reduced by 100 shares of Stock X short position exposure as a result of the forward contract. FB is required to withhold on dividend equivalent payments to Customer on the forward contract in accordance with § 1.1441-2(e)(7).

Example 2. At-the-money option contract entered into by a foreign equity derivatives dealer.

(i) *Facts.* The facts are the same as Example 1, but Customer purchases from FB an at-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.5, and FB hedges the call option by entering into a total return swap that references 50 shares of Stock X with U.S. Broker. At the end of the day on the date provided in paragraph (j)(2) of this section for the dividend, the call option has a delta of 0.6, FB hedges the call option with a total return swap that references 60 shares of Stock X with U.S. Broker, and FB has no

shares of Stock X or other transactions that reference Stock X.

(ii) *Application of rules.* At the end of the day on the date provided in paragraph (j)(2) of this section for the dividend, FB is a long party on 60 shares of Stock X through the total return swap and a short party on an option. Because the option has a delta of less than 0.8 at the calculation time, it is not a section 871(m) transaction. Therefore, there will be no dividend equivalent payments made by FB to Customer that are subject to withholding. Pursuant to § 1.1441-1(b)(4)(xxii), U.S. Broker is not obligated to withhold on the dividend equivalents with respect to Stock X paid to FB because U.S. Broker has received valid documentation that it may rely upon to treat the dividend equivalents as paid to FB acting as a qualified derivatives dealer. The net delta exposure is zero at the end of the day on the date provided in paragraph (j)(2) of this section for the dividend because FB has a long position of 60 shares as a result of the total return swap, which is reduced by FB's short position of 60 shares as a result of the option.

Example 3. In-the-money option contract entered into by a foreign equity derivatives dealer.

(i) *Facts.* The facts are the same as Example 2, but Customer purchases from FB an in-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.8 and FB hedges the call option by purchasing 80 shares of Stock X, which are held in an account with U.S. Broker, who also acts as paying agent. The price of Stock X declines substantially and the option lapses unexercised. At the end of the day on the date provided in paragraph (j)(2) of this section for the dividend, the call option has a delta of 0.48 and FB has reduced its hedge to 50 shares of Stock X with U.S. Broker. In addition, on that date, FB owns no other shares of Stock X or any other transactions that reference Stock X in its equity derivatives dealer capacity.

(ii) *Application of rules.* At the end of the day on the date provided in paragraph (j)(2) of this section for the dividend, FB is a long party on 50 shares of Stock X and a short party on an option. Because the option has a delta of 0.8 at the calculation time, it is a section 871(m) transaction. Therefore, FB is required to withhold on dividend equivalent payments to Customer on the option contract in accordance with § 1.1441-2(e)(7). U.S. Broker is required to withhold on the Stock X dividends paid to FB. Assuming that FB is a qualified resident of a country that provides withholding on dividends at a 15 percent rate, U.S. Broker is required to withhold on the dividends with respect to the 50 shares of stock held by FB. FB's net delta exposure is two shares of Stock X at the end of the day on the date provided in paragraph (j)(2)

of this section because FB has a long position of 50 shares, reduced by FB's short position of 48 shares as a result of the option. FB's section 881 tax on the \$0.50 (two shares multiplied by a dividend of \$0.25 per share) is reduced (but not below zero) by the section 881 tax amount paid by qualified derivatives dealer on the 50 shares. Therefore, FB's section 871(m) amount is zero.

(r) *Effective/applicability date*—(1) *In general.* This section applies to payments made on or after September 18, 2015 except as provided in paragraphs (r)(2), (3), and (4) of this section.

(2) *Effective/applicability date for paragraph (d)(1)(i).* Paragraph (d)(1)(i) of this section applies to payments made on or after January 23, 2012.

(3) *Effective/applicability date for paragraphs (d)(2) and (e).* Paragraphs (d)(2) and (e) of this section apply to any payment made on or after January 1, 2017, with respect to any transaction with a delta of one issued on or after January 1, 2017. Paragraphs (d)(2) and (e) of this section apply to any payment made on or after January 1, 2018, with respect to any other transaction issued on or after January 1, 2018. Notwithstanding the prior sentence, paragraphs (d)(2) and (e) of this section will apply to any payments made on or after January 1, 2020, with respect to the exchange-traded notes issued on or after January 1, 2017, that are identified in a separate notice, and not payments made before January 1, 2020, with respect to those notes. Notwithstanding the first sentence of this paragraph (r)(3), paragraphs (d)(2) and (e) of this section do not apply to payments made in 2017 to a qualified derivatives dealer in its equity derivatives dealer capacity to hedge transactions that have a delta of less than one.

(4) *Effective/applicability date for paragraphs (g)(4)(ii)(B), (p)(1)(ii) through (iv), and (p)(5) of this section.* Paragraphs (c)(2)(iv), (h), and (q) of this section apply to payments made on or after January 1, 2017.

(5) *Effective/applicability date for paragraphs (g)(4)(ii)(B), (p)(1)(ii) through (iv), and (p)(5) of this section.* [Reserved]. For further guidance, see § 1.871-15T(r)(5).

[T.D. 9648, 78 FR 73080, Dec. 5, 2013, as amended by T.D. 9734, 80 FR 56879, Sept. 18, 2015; 80 FR 75946, Dec. 7, 2015; T.D. 9815, 82 FR 8155, 8160, Jan. 24, 2017]

§ 1.871-15T Treatment of dividend equivalents (temporary).

(a) [Reserved]. For further guidance, see § 1.871-15(a).

(1) *Broker.* A *broker* is a broker within the meaning provided in section 6045(c), except that the term does not include any corporation that is a broker solely because it regularly redeems its own shares.

(a)(2) through (g)(4)(ii)(A) [Reserved]. For further guidance, see § 1.871-15(a)(2) through (g)(4)(ii)(A).

(B) A foreign securities exchange that:

(1) Is regulated or supervised by a governmental authority of the country in which the market is located;

(2) Has trading volume, listing, financial disclosure, surveillance, and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open, fair and orderly market, and to protect investors, and the laws of the country in which the exchange is located and the rules of the exchange ensure that those requirements are actually enforced;

(3) Has rules that effectively promote active trading of listed options on the exchange; and

(4) Has an average daily trading volume on the exchange exceeding \$10 billion during the immediately preceding calendar year. If an exchange in a foreign country has more than one tier or market level on which listed options may be separately listed or traded, each tier or market level is treated as a separate exchange.

(g)(5) through (p)(1)(i) [Reserved]. For further guidance, see § 1.871-15(g)(5) through (p)(1)(i).

(ii) *Transactions with multiple brokers.* For a potential section 871(m) transaction in which both the short party and an agent or intermediary acting on behalf of the short party are a broker or dealer, the short party must determine whether the potential section 871(m) transaction is a section 871(m) transaction. For a potential section 871(m) transaction in which the short party is not a broker or dealer and more than one agent or intermediary acting on behalf of the short party is a broker or dealer, the broker or dealer